COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, SEPTEMBER 28, 2001

APPLICATION OF

WASHINGTON GAS LIGHT COMPANY

and

THE SHENANDOAH GAS DIVISION OF
WASHINGTON GAS LIGHT COMPANY

CASE NO. PUE010354

For approval of an amendment
to their respective Purchased
Gas Charge Provisions

FINAL ORDER

On June 20, 2001, Washington Gas Light Company and The Shenandoah Gas Division of Washington Gas Light Company (hereinafter collectively referred to as "the Companies" or "the Applicants") filed an application with the State Corporation Commission ("Commission") to amend the Purchased Gas Charge ("PGC") provisions of their respective gas tariffs on file with the Commission. In their application, the Companies represented that the purpose of the proposed amendments was to provide explicitly for the recovery by the Applicants of costs associated with gas price hedging transactions through their respective PGC provisions.

The Applicants explained that in view of the volatility of natural gas prices experienced during the winter of 2000-2001, they were considering ways to manage the risks associated with natural gas prices in the upcoming winter, including the use of financial hedging in their gas purchasing practices. Financial hedging of natural gas prices, according to the Companies, may take a variety of forms, including the purchase of futures contracts, the purchase of call options, or a combination of the foregoing. The Applicants contended that the costs involved in engaging in hedging transactions were recoverable through the language now found in their respective PGC provisions, but maintained that it would be in the interest of their customers to provide clarity in their tariff provisions in order to eliminate any potential barrier to the use of financial hedging strategies.

On July 6, 2001, the Commission entered an Order docketing the captioned application and suspending the Applicants' proposed tariff revisions pursuant to § 56-238 of the Code of Virginia to permit the further investigation of the application.

On July 12, 2001, the Commission entered its Order for Notice and Hearing. In that Order, the Commission directed the Companies to publish notice of their applications, invited interested parties to file written comments or requests for hearing with the Commission on or before August 20, 2001, and directed the Commission Staff to file a report that could take the form of testimony on or before August 29, 2001. The Commission invited interested parties and the Companies to file their responses to the Staff's report on or before September 14, 2001.

On August 28, 2001, the Companies, by counsel, filed their proof of publication and service of the Order as required by Ordering Paragraph (6) of the July 12, 2001 Order for Notice and Hearing.

No comments or requests for hearing were filed in this proceeding.

On August 29, 2001, the Staff filed its report with the Commission in both a public and confidential version. In its report, the Staff noted that the Applicants intended to use three types of hedged gas commodity contracts offered by third parties that have expertise in risk management, gas markets, and fixed price contracts in which risk management techniques were utilized. These hedged commodity contracts included a price cap product,[1] a price band product,[2] and a fixed price product.[3]

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[1] Price cap contracts established a maximum overall price or cap for a specified volume of gas over a specified period. Below the cap, the price of gas would be based on a market index price plus a fixed adder or premium to compensate the counterparty for the capped price obligation.

[2] A price band contract would require the Applicants to pay a market index price up to a maximum cap price and down to a minimum floor price. The entity obligated to supply gas to Applicants under the terms of the hedged contract (counterparty) would receive compensation for its assumption of the maximum price cap risk through the Applicants' contractual obligation to the floor or minimum price.

[3] The fixed price contract hedging product establishes a specific price for a specific volume of gas over a specific period. The specific period may encompass an entire heating season or particular months within the heating

All of these hedging products involve a cost for their use. Staff noted that of the three types of hedged contracts, only the price cap contract explicitly reflects the "costs" of that product through an adder or premium on each unit of gas purchased below the cap. Staff explained that the costs for the two other types of products were implicitly embedded in the premium over current gas costs for the fixed price product, and the level of the price floor in the price band product.

The Staff commented that the wholesale natural gas market had experienced exceptionally high prices over the past heating season, with spot gas prices rising to a new plateau of $9-10 per MMBtu in December and January, more than double the average price of the previous winter. Staff noted that the use of financial hedging instruments could be appropriate for gas utilities to help dampen the spikes in gas costs.

Summarizing the Applicants' proposal, the Staff reported that the Companies propose to limit the gas volumes to be hedged to 75% of their maximum daily take obligation per month.[4] The Staff explained that the Applicants' proposed to use the lowest daily volume (warmest day) of firm demand gas in each month of the winter heating season over the last five years to calculate

season. The cost of this type of contract is embedded in the difference between the fixed price and the current price of gas.

[4] The Applicants define the "Maximum Daily Take Obligation" as follows: Maximum Daily Take Obligation = (Minimum Daily Firm Load + Storage Injection Capability) - (Firm Delivery Service + Excess Interruptible Delivery Service).

a volume of firm gas for the corresponding month in a winter heating season profile. The lowest volume of gas for each month from this heating season profile was further reduced by a conservative estimate of the firm gas volume to be supplied by competitive suppliers. The Applicants then reduced the conservative volume estimate by an additional 25% to arrive at the "Maximum Daily Take Obligation".

The Staff recommended that prudently incurred costs resulting from the use of a Commission-approved gas supply hedging program should be recovered through the Companies' respective purchased gas adjustment ("PGA") clauses without reference to other hypothetical or imputed gas supply costs. The Staff cautioned the Companies that imprudent purchased gas costs could be excluded from recovery through these clauses. Staff recommended that the Applicants be authorized to enter into the three types of hedged gas commodity contracts for up to 75% of their maximum daily take obligation per month, as further explained in Confidential Exhibit 1, Attachment 1-2 to the report. Staff proposed that the Commission grant authority to the Companies to engage in hedging activities in accordance with the recommendations of the report through the 2005-2006 winter heating season.[5] According to Staff, this limitation would

[5] The heating season for these Companies is generally defined as October through March of a given year.

provide a reasonable length of time to evaluate whether the Companies' hedging activity should be modified or continued.

Further, the Staff recommended that the Applicants be required to file a report on or before June 30 of each year during the period 2002 through 2005, which sets out the terms of the hedged gas contracts and the calculation of the 75% maximum daily take obligation that will govern the hedged contract volumes for the next heating season. Staff additionally requested that the captioned docket be left open to receive the Companies' reports.

Staff also recommended that the Applicants' tariff language be modified to include costs associated with hedged gas contracts that do not cumulatively exceed 75% of the Companies' maximum daily take obligation as further explained in Confidential Exhibit No. 1 to the Staff Report. Staff proposed that the Applicants account for their hedging methodology, as indicated in Exhibit No. 2 to the public version of the Staff Report.

Finally, the Staff recommended at page 15 of its report that if the proportion of the Companies' gas supply portfolio to be hedged expanded or if the Applicants change their proposed hedging methodology, they be required to adopt a risk management policy, that at a minimum, addresses their objectives for risk management activities. According to Staff, such a risk management policy should include a policy statement, definitions of important terms related to risk management, a statement forbidding speculation, a description of the types of transactions allowed under the policy, and internal documentation requirements.

On September 10, 2001, the Companies, by counsel, filed their comments on the Staff report. In their comments, the Company filed proposed tariffs and generally supported the Staff's recommendations. Specifically, the Applicants supported the Staff recommendation found at page 14 of the Staff report regarding the recovery of prudently incurred costs associated with hedging activities.

NOW, UPON consideration of the Company's application, the Staff report, and the comments of the Companies thereon, the Commission is of the opinion and finds that the Companies' application, as modified by the recommendations set out in the August 29, 2001, Staff report and the modifications made herein, is reasonable and should be adopted; that the Companies should be granted authority to engage in hedging activities through the 2005-2006 winter heating season; that the Companies should account for their hedging transactions as indicated in Exhibit No. 2 to the August 29, 2001 Staff report; that the Applicants should file a report on or before June 30 of each year for the period 2002 through 2005, which should describe in detail the terms of the hedged gas contracts utilized in the prior heating season, any costs associated with the hedged gas contracts, and the calculation of the 75% maximum daily take obligation that will govern the volumes specified in the hedging contracts for the next heating season; that by June 30th of the 2005 heating season, the Companies should file a pleading requesting authority to continue the hedging program, amend the hedging program, or terminate the same; that in the event the Companies choose to expand the proportion of their gas supply portfolio that will be hedged or change their proposed hedging methodology, the Companies should seek additional authority from the Commission, and should also adopt a risk management policy addressing, at a minimum, the matters described at page 15 of the public version of the August 29, 2001 Staff report.

We find it unnecessary to address the prudency of hedging costs. The recovery of costs associated with gas hedging activities is more appropriately determined in a rate case or some other proceeding in which specific facts may be adduced.

Finally, we find that the proposed tariff pages appended as Attachments 1 and 2 to the Companies' September 7, 2001 comments should be revised to incorporate the 2005-2006 heating period for which authority has been granted herein as well as to reference the price cap, the price band, and the fixed price hedging instruments the Companies propose to use and which we have approved. We will therefore require the Companies to file tariffs conforming with our directives with the Division of Energy Regulation, effective for service rendered on and after the date of this Order. These tariffs should identify on their face the methodology the Companies intend to use to determine the 75% maximum daily take obligation in a manner that can be reviewed by the public generally.

Accordingly, IT IS ORDERED THAT:

(1) The Companies' application, as modified by the recommendations set out in the August 29, 2001 Staff Report and the directives of this Order, is hereby granted.

(2) The Companies are authorized to utilize price cap, price band, and fixed price hedged gas contracts through the 2005-2006 winter heating season.

(3) The Companies shall forthwith file with the Division of Energy Regulation tariffs conforming with the directives of this Order, to be effective for service rendered on and after the date of this Order.

(4) The Companies shall file a report with the Clerk of the Commission on or before June 30 of each year for the period beginning 2002 through 2005. Said report shall describe in detail the terms of the hedged gas contacts utilized in the prior heating season, any costs associated with hedged gas contracts, and the calculation of the maximum daily take obligation that will govern the hedging contract volumes for the next heating season.

(5) By June 30 of the 2005 heating season, the Companies shall file a pleading with the Clerk of the Commission,

requesting authority to continue the hedging program, amend the hedging program, or terminate the same.

(6) If, during the course of the hedging program, the Companies desire to expand the proportion of their gas supply portfolio that will be hedged or change their proposed hedging methodology, the Companies shall seek additional authority from the Commission to do so, and shall adopt a risk management policy, that at a minimum, addresses the matters described at page 15 of the August 29, 2001 Staff report.

(7) The Companies shall account for their hedging activities as indicated in Exhibit No. 2 to the Staff's August 29, 2001 report.

(8) This docket shall remain open to receive the reports and other pleadings required by this Order.